POL-001-92

POLICY TO ESTABLISH ACCOUNTING AND AUDITING STANDARDS PURSUANT TO I.C. 28-13-10-8

Effective July 1, 1992, I.C. 28-13-10-8 requires the Board of Directors of each corporation to engage a Certified Public Accountant to perform an examination (audit) of the corporation one time each calendar year. A corporation is defined by IC 28-10. The Department establishes the following accounting and auditing standards necessary to comply with the examination (audit) requirements of this section by the adoption of this policy. The corporation shall utilize one the following options to comply with the examination requirement contained in IC 28-13-10-8:

1. **FULL SCOPE AUDIT**
   The Board of Directors of the corporation may engage an independent Certified Public Accountant or firm of Certified Public Accountants, to perform an audit of the corporation's financial statements in accordance with Generally Accepted Accounting Principles (GAAP) and include financial statement disclosures required by current accounting literature.

An audit of the corporation's holding company will satisfy the requirements of the statute for the corporation if the audit is conducted in accordance with the requirements of this option. The Department reserves the right pursuant to IC 28-11-3-1 to require a holding company subsidiary to undergo separate external auditing and reporting procedures if the institution is deemed by the Department to be involved in high-risk activities.

2. **RESTRICTED SCOPE BALANCE SHEET ONLY AUDIT**
   The Board of Directors of the corporation may engage an independent Certified Public Accountant or firm of Certified Public Accountants to perform an audit of the corporation's balance sheet (Statement of Condition) in accordance with GAAS, except that an evaluation of the adequacy of the allowance for loan and lease losses account may be omitted. The risk-based procedures with respect to the allowance for loan and lease losses identified in the attached addendum must be performed. The corporation's balance sheet (Statement of Condition) shall be presented in accordance with GAAP and include financial statement disclosures required by current accounting literature.

   A minimum standard of audit procedures must be performed in specific areas of bank operations where the risk factor may be material. The risk-based procedures which must be performed to comply with the requirement of this policy are based upon the statement of policy issued by the Federal Deposit Insurance Corporation (FDIC). The FDIC policy, which provides guidance on external auditing procedures for State non-member banks, became effective January 16, 1990. These risk-based procedures are defined in detail in an addendum to this policy. The accountant's report must state that the Restricted Scope Balance Sheet Only Audit included the performance of the risk-based procedures which are contained in the addendum to this policy.

Both options require an audit to be performed in accordance with GAAS as adopted by the American Institute of Certified Public Accountants (AICPA). Additional requirements of these options are as follows:

A. Communications required under GAAS concerning internal control structure and other related audit matters must be in compliance with current Statement on Auditing Standards (SAS) literature except that all such communications must be documented in writing in the management letter.

B. The audit report, management letter, and other audit related communications as required under GAAS must be submitted to the Department within 120 days of the financial statement(s) date.

C. The Board of Directors of the corporation shall establish an audit policy including internal and external programs, and review its appropriateness annually. The review shall be documented in the minutes of the Board meeting.

D. All audit services required by this policy shall be performed only by an independent Certified Public Accountant or firm of Certified Public Accountants who (1) has agreed in writing to provide the Department access to all work papers and other audit documentation requested by the Department; and (2) is currently in compliance with a peer review program that meets guidelines which are acceptable to the Director of the Department. A Certified Public Accountant or firm of Certified Public Accountants will automatically qualify under this requirement if it has received a current unqualified report under the American Institute of Certified Public Accountants Quality Review Program or either the Securities and Exchange Commission or Private Companies Practice Sections of the AICPA. An independent Certified Public Accountant or firm of Certified Public Accountants receiving a peer review report other than that described above must submit the report to the Director of the Department together with a request for approval to provide services required by this Policy. The Director of the Department will advise the accountant in writing whether the request is approved or denied.

E. Each corporation shall provide written notification to the Department of the resignation or dismissal of the corporation's independent auditor or the engagement of a new independent auditor by the corporation. A notification disclosing the reasons for such change must be submitted to the Department within fifteen (15) calendar days of the occurrence of the event.

ADDENDUM
RISK-BASED PROCEDURES
LOANS

1. Inquire as to whether the bank has policies that address the lending and collection functions. Review the bank's loan policies to ascertain whether they address the following items:

A. General fields of lending in which the bank will engage and types of loans within each field;

B. Descriptions of the bank's normal trade area and circumstances under which the bank may extend credit to borrowers outside of such area;

C. Limitations on the maximum volume of each type of loan product in relation to total assets;

D. Responsibility of the board of directors in reviewing, ratifying or approving loans;

E. Lending authority of the loan or executive committee (if such a committee exists) and individual loan officers or classes or officers;

F. Adherence to legal lending limits;

G. Types of loans, specifying whether secured and unsecured, which will be granted;

H. Circumstances under which extensions or renewals of loans are permitted;

I. Guidelines for rates of interest and terms of repayment for loans;

J. Documentation required by the bank for each type of loan;

K. Limitations on the amount advanced in relation to the value of various types of collateral;

L. Limitations on the extension of credit through overdrafts;

M. Level or amount of loans granted in specific industries or specific geographic locations;

N. Guidelines for participation purchased and/or sold;

O. Guidelines for documentation of new loans prior to approval, updating loan files throughout the life of the loan, and maintenance of complete and current credit files on each borrower;

P. Guidelines for loan review procedures by bank personnel including:

   1. An identification or grouping of loans that warrant the special attention of management;

   2. For each loan identified, a statement or indication of the reason(s) why the particular loan merits special attention; and

   3. A mechanism for reporting periodically to the board on the status of each loan identified and the action(s) taken by management.

Q. Collection procedures, including, but not limited to, actions to be taken against borrowers who fail to make timely payments;

R. Guidelines for nonaccrual loans (i.e., when an asset should be placed in nonaccrual status, individuals responsible for identifying nonperforming assets and placing them in nonaccrual status, and circumstances under which an asset will be placed back on accrual);

S. Guidelines for loan charge-offs;

T. Guidelines for in-substance foreclosures.

2. Read the board of directors' minutes to determine that the loan policies have been reviewed and approved. Through review of the board of director's minutes and through inquiry of executive officers, determine whether the board of directors revises the policies and procedures periodically as needed.

3. Obtain the minutes of the board of directors and/or loan committee, as appropriate, and through a comparison of a sample of loans made throughout the period with lending policies, test whether loans funded during the previous year were properly authorized by the appropriate committee or loan officer(s) and within the bank's lending limits.

4. Select a sample of borrowers (including loans from each major secured and unsecured loan category) and determine through examination of loan files and other bank reports whether lending and collection policies are being followed (e.g., type of loan and any extension or renewal of a previous loan are in accordance with loan policy, funds were not advanced until after loan approval was received from proper loan authorization level, and insurance coverage is adequate with the bank named as loss payee).

5. Using the sample of borrowers selected from each major category of secured loans, determine through examination of files and other bank reports whether collateral policies are being followed (e.g., loan is adequately collateralized, documentation is present and properly prepared, and assignments are perfected).

6. If material, review policies for lending on floor plan merchandise, warehouse inventory, and accounts receivable to determine that limitations on such loans and directions on verification of collateral by bank inspection are included in the policies. Ascertain that implementing procedures have been established and test for compliance by responsible bank personnel.

7. Determine whether participation purchased and participation sold transactions have been reported to and authorized by the board of directors or loan committee, if applicable, through review of appropriate minutes.

8. Confirm a sample of participation purchased and participation sold with participating banks to verify that they are legitimate transactions and that they are properly reflected as being with or without recourse in the bank's records.

9. Balance detail ledgers or reconcile computer-generated trial balances with the general ledger control accounts for each major category of loans, including loans carried as past due or in a nonaccrual status.

10. Confirm a sample of all loans within each major category, including past due and nonaccrual status.

11. Review accrued interest on loans by:

    A. determining the bank's method of calculating and recording interest accruals;

    B. obtaining trial balances of accrued interest;

    C. testing the reconciliation of the trial balances to the general ledger;

    D. determining that interest accruals are not made on nonaccrual loans;

ALLOWANCE FOR LOAN LOSSES

1. Test charge-offs and recoveries for proper authorization and/or reporting by reference to the board of directors' minutes. Review charged-off loans for any relationship with bank insiders or their related interests.

2. Review the bank's quarterly procedures for determining the adequacy of the allowance for loan losses. The review must determine whether these procedures enable the bank to make a reasonable estimate of the required ALLL balance and whether the steps are properly documented. Documentation should include consideration of the following matters:

    A. General, local national and international (if applicable) economic conditions;

    B. Trends in loan growth and depth of lending staff with expertise in these areas;

    C. Concentrations of loans (e.g., by type, borrower, geographic area, and sector of the economy);

    D. The extent of renewals and extensions to keep loans current;

    E. The collectibility of nonaccrual loans, as determined by the bank;

F. Trends in the level of delinquent and adversely classified loans compared with previous loan loss and recovery experience;

G. Results of regulatory examinations; and

H. The collectibility (as determined by the bank) of specific loans on the “watch list” taking into account borrower financial status, collateral type and value, payment history, and potential permanent impairment.

SECURITIES

1. Review the investment policies and procedures established by the bank’s board of directors (BOD). Review the BOD (or investment committee) minutes for evidence that these policies and procedures are periodically reviewed and approved. The policies and procedures should include, but not be limited to:

   A. Investment objectives, including use of “held for sale” and trading activities;

   B. Permissible types of investments;

   C. Diversification guidelines to prevent undue concentration;

   D. Maturity schedules;

   E. Limitation on quality ratings;

   F. Hedging activities and other uses of futures, forwards, options, and other financial instruments;

   G. Handling exceptions to standard policies;

   H. Valuation procedures and frequency;

   I. Limitations on the investment authority of officers; and

   J. Frequency of periodic reports to the BOD on securities holdings.

2. Test the investment procedures and ascertain whether information reported to the BOD (or investment committee) for securities transactions is in agreement with the supporting data by comparing the following information on such reports to the trade tickets for a sample of items (including futures, forwards, and options):

   A. Descriptions

   B. Interest rate

    C. Maturity

    D. Par value, or number of shares
    E. Cost

    F. Market value on date of transaction (if different than cost).

3. Using the same sample items, analyze the securities register for accuracy and confirm the existence of the sample items by examining securities physically held in the bank and confirming the safekeeping of those securities held by others.

4. Balance investment sub-ledger(s) or reconcile computer-generated trial balances with the general ledger control accounts for each type of security.

5. Review policies and procedures for controls which are designed to ensure that unauthorized transactions do not occur. Ascertain through reading of policies, procedures, and BOD minutes whether investment officers and/or appropriate committee members have been properly authorized to purchase/sell investments and whether there are any limitations or restrictions on delegated responsibilities.

6. Obtain a schedule of the book, par, and market values of securities as well as their rating classifications. Test the accuracy of the market values of a sample of securities and compare the ratings listed to see that they correspond with those of the rating agencies. Review the bank's documentation on any permanent declines in value that have occurred among the sample of securities to determine that any recorded declines in market value are appropriately computed. Examine the bank's computation of the allowance account for securities, if any, for proper presentation and adequacy.

7. Review accrued interest on securities by:

    A. Determining the bank's method of calculating and recording interest accruals;

    B. Obtaining trial balances of accrued interest;

    C. Testing the reconciliation of the trial balances to the general ledger;

    D. Determining that interest accruals are not made on defaulted issues;

8. Review investment accounts for volume of purchases, sales activity and length of time securities have been held. Inquire as to the bank's intent and ability to hold securities until maturity. (If there is frequent trading in an investment account, such activity may be inconsistent with the notion that the bank has the intent and ability to hold securities to maturity).

INSIDER TRANSACTIONS

1. Review the bank’s policies and procedures to ensure that extensions of credit to and other transactions with insiders(*) are addressed. Ascertain that these policies include specific guidelines defining fair and reasonable transactions between the bank and insiders and test insider transactions for compliance with these guidelines and statutory and regulatory requirements. Ascertain that the policies and procedures on extensions of credit comply with the requirements of Federal Reserve Regulation O.

   (*) For the purposes of this section of the auditing procedures, insiders include all affiliates of the bank (including its parent holding company) and all subsidiaries of the bank, as those terms are defined in Section 23A of the Federal Reserve Act, as well as the bank’s executive officers, directors, principal shareholders, and their related interests, as those terms are defined in section 215.2 of Federal Reserve Regulation O.

2. Obtain a bank-prepared list of insiders, including any business relationships they may have other tan as a nominal customer. Also obtain a list of extensions of credit to and other transactions that the bank, its affiliates, and its subsidiaries have had with insiders that are outstanding as of the audit date or that have occurred since the prior year’s external auditing procedures were performed. Compare these lists to those prepared for the prior year’s external auditing program to test for completeness.

3. Review the board of directors’ minutes, loan trial balances, supporting loan documentation, and other appropriate bank records in conjunction with the list of insiders obtained from the bank to verify that a sample of extensions of credit to and transactions with insiders were:

   A. In compliance with bank policy for similar transactions and were at prevailing rates and terms at that time;

   B. Subjected to the bank’s normal underwriting criteria and deemed by the bank to involve no more than a normal degree of risk or present no other unfavorable features;

   C. Approved by the board of directors in advance with the interested party abstaining from voting; and

   D. Within the aggregate lending limits imposed by Regulation O or other legal limits.

4. Review the bank’s policies and procedures to ensure that expense accounts of individuals who are executive officers, directors, and principal shareholders are addressed and test a sample of the actual expense account records for compliance with these policies and procedures.

INTERNAL CONTROLS
GENERAL ACCOUNTING AND ADMINISTRATIVE CONTROLS

1. Review the board of directors' minutes to verify that account reconciliation policies have been established and approved and are reviewed periodically by the BOD. Determine that management has implemented appropriate procedures to ensure the timely completion of reconciliations of accounting records and the timely resolution of reconciling items.

2. Determine whether the bank's policies regarding segregation of duties and required vacations for employees (including those involved in the EDP function) have been approved by the BOD, and verify that these policies and the implementing procedures established by management are periodically reviewed, are adequate, and are followed.

3. Confirm a sample of deposits in each of the various types of deposit accounts maintained by the bank. Inquire about controls over dormant deposit accounts.

4. Test to determine that reconciliations are prepared for all significant asset and liability accounts and their related accrued interest accounts, if any, such as "due from" accounts; demand deposits; NOW accounts; money market deposit accounts; other savings deposits; certificates of deposits; and other time deposits. Review reconciliations for:

   A. Timeliness and frequency;

   B. Accuracy and completeness; and

   C. Review by appropriate personnel with no conflicting duties.

5. Compare a sample of balances per reconciliations to the general ledger and supporting trial balances.

6. Examine detail and aging of a sample of reconciling items from those accounts whose reconciliations have been tested and reviewed and a sample of items in suspense, clearing, and work-in-process accounts by:

   A. Testing aging;

   B. Determining whether items are followed up on and appropriately resolved on a timely basis; and

   C. Discussing items remaining on reconciliations and in the suspense account with appropriate personnel to ascertain whether any should be written off.

   Review a sample of charged-off reconciling and suspense items for proper authorization.

7. Verify through inquiry and observation that the bank maintains adequate records of its off-balance sheet activities, including, but not limited to, its outstanding letters of credit and its loan commitments. Review the bank's procedures for monitoring the extent of its credit exposure from such activities to determine whether probable or reasonably possible losses exist.

ELECTRONIC DATA PROCESSING CONTROLS

1. Read the BOD's minutes to determine whether the BOD has reviewed and approved the bank's electronic data processing (EDP) policies (including those regarding outside services, if any, and the in-house use of individual personal computers (PCS) and personalized programs for official bank records) at least annually, confirm that management has established appropriate implementing procedures, and verify the bank's compliance with these policies and procedures.

   A. The policies and procedures for either in-house processing or use of an outside service center should include:

      1. A contingency plan for continuation of operations and recovery when power outages, natural disasters, or other threats could cause disruption and/or major damage to the institution's data processing support (including compatibility of service's plan with that of the bank); [see note}

      2. Requirements for EDP-related insurance coverage which include the following provisions:

         (a) extended blanket bond fidelity coverage to employees of the bank or service;

         (b) insurance on documents in transit, including cash letters; and

         © verification of the insurance coverage of the bank or service bureau and the courier service;

      3. Review of exception reports and adjusting entries approved by supervisors and/or officers;

      4. Controls for input preparation and control and output verification and distribution;

      5. "back-up" of all systems, including off-premises rotation of files and programs;

      6. Security to ensure integrity of data and system modifications; and

7. necessary detail to ensure an audit trail.

B. When an outside service center is employed, the policies and procedures should address the following additional items:

1. The requirement for a written contract for each automated application detailing ownership and confidentiality of files and programs, fee structure, termination agreement, and liability for documents in transit;

2. Review of each contract by legal counsel; and

3. Review of each third party review of the service bureau, if any.

For further guidance, see the July 1989, FFIEC Policy on Contingency Planning for Financial Institutions and Section 7 of the FFIEC EDP Examination Handbook. For further guidance on using a third-party report, see the American Institute of Certified Public Accountant's Audit and Accounting Guide, Audits of Service-Center Produced Records.

2. In the area of general EDP controls, determine through inquiry and observation that policies and procedures have been established for:

A. Management and user involvement and approval of new or midfield application programs;

B. Authorization, approval and testing of system software modifications;

C. The controls surrounding computer operations processing;

C. Restricting access to computer operations facilities and resources including:

1. Off -premises storage of master disks and PC disks;

2. Security of the data center and bank's PCS; and

3. Use and periodic changing of passwords.

3. With respect of EDP applications controls, inquire about and observe:

A. The controls over:

1. Input submitted for processing,

2. Processing transactions,

3. Output,

4. Applications on PCS, and

5. Telecommunications both between and within bank officers;

B. The security over unissued or blank supplies of potentially negotiable items; and

C. The control procedures on wire transfers including:

1. Authorizations and agreements with customers, including who may initiate transactions,

2. Limits on transactions, and

3. Call back procedures.

Extent of Testing

Where the procedures set forth above require testing or determinations to be made, sampling may be used. Both judgmental and statistical sampling may be acceptable methods of selecting samples to test. Judgmental sampling may be particularly suitable for small banks, and sample sizes should be selected consistent with generally accepted auditing standards.

As with any auditing program under generally accepted auditing standards or otherwise, if an auditing procedure that is set for the above deals with an are or account of the bank in which the amounts and/or risks are not material to the bank’s operations and financial results based on the experience and judgement of the auditor, the procedure may be omitted from the year’s auditing program. Nevertheless, the auditor would have to review each such area or account each year in order to determine whether to reaffirm his/her conclusion.